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## **Charitable Donation of Deconstructed House Denied**

**By: Dimple Mukhi, MST Student**

Mann v. U.S., 127 AFTR 2d 2021-447 (4th Cir.), affirmed the judgment of the U.S. District Court for the District of Maryland (123 AFTR2d 2019-599 (DC MD)). The ruling was against the taxpayers and upheld the IRS disallowance of charitable deductions of \$675,000 and \$24,206 on the couple's 2011 joint income tax return for donation of house components to Second Chance, Inc., a non-profit property deconstruction organization.

### **Background of the case**

Linda and Lawrence Mann challenged the district court's judgment affirming the IRS's disallowance of a charitable deduction claimed on their 2011 joint income tax return. The Manns had purchased a residence in Bethesda, Maryland referred to as 5300 Moorland Lane. They decided to demolish the existing house and build a new one on the property due to water issues in the basement and to make desired changes to the house's layout. The Manns were advised by their builders to consider working with Second Chance<sup>1</sup> not only to advance the organization's charitable cause but also to obtain a charitable tax deduction.

### **About Second Chance, Inc., a charitable organization**

Second Chance offers deconstruction services to foster its mission of providing "workforce development and job training opportunities to disadvantaged members of the community," and also preventing "salvageable building materials and fixtures from ending up in landfills." The employees are paid an hourly wage and learn construction skills. Second Chance can perform a "systematic dismantling of a structure" to remove some building components for resale or recycle. Some building components, like drywall, tile, and roofing materials, are certainly destroyed as part of the deconstruction process, and some are destroyed as part of employee training. However, Second Chance does not provide demolition services and advises potential donors to do that at their own expense. Second Chance also asks deconstruction donors to make a cash contribution to help defray the costs of its training program for disadvantaged individuals. They usually don't accept a deconstruction project that lacks such funding unless the salvaged materials have historical significance.

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<sup>1</sup> Second Chance, Inc., is a charitable organization under section 501(c)(3) of the Internal Revenue Code.

## **Facts of the case**

### **House donation**

After learning about Second Chance, Linda Mann signed an agreement with Second Chance which stated that the Manns donated the existing house in its totality<sup>2</sup> to Second Chance but specifically excluded the underlying land or the foundation on which the residential dwelling was built. The Sales Manager of Second Chance assured the Manns of the possibility of a charitable tax deduction and agreed to assist with the paperwork to provide evidence and support for the deduction. The Sales Manager also explained that if they followed the tax law and determined the value for the deduction based on a qualified appraisal performed by a qualified appraiser, they should be entitled to the deduction. For the purposes of determining the amount of charitable deduction on the federal tax return, the Manns engaged NoVaStar Appraisals, Inc., to provide an appraisal. The appraiser calculated \$675,000 as the value of the house without the land based on the “highest and best use” of the house. The appraiser established the fair market value of the entire property as \$1,875,000, which included \$1,200,000 as the market value of the land. The appraiser subtracted the market value of the land from the fair market value of the entire property and concluded that the value of the intact house without land was \$675,000. The appraiser assessed the value of the house “without disassembly” and concluded that the “highest and best use” of the house was “not disassembly, but rather physically moving the structure intact to another lot.” The Manns took a charitable deduction of \$675,000 on their income tax return for 2011.

### **Personal property donation**

Deconstruction is generally divided into two phases: the first phase is removal of non-structural interior elements, and the second phase is removal of structural exterior elements. Second Chance completed the deconstruction on July 6, 2012 and stated that it was unable to extract as much material as expected. Also, Second Chance did not maintain a list of items removed from the second phase of deconstruction of 5300 Moorland Lane. The first phase of deconstruction included items such as appliances, granite counter tops, solid wood interior doors, and 2400 square feet of wood flooring. The Manns prepared a list of 40 items of furniture and home decorations that they donated to Second Chance that was valued at \$24,206 by NoVaStar Appraisals, Inc. The Manns claimed a charitable deduction of \$24,206 on their 2011 income tax return for the personal property donated.

### **Cash donation**

To finance the costs of its training program, Second Chance asked the Manns to make a cash donation of \$20,000. The Manns donated \$10,000 in 2011 and took a deduction of this amount on their 2011 income tax return. In 2012, they donated \$1,500 and took a deduction on their 2012 income tax return.

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<sup>2</sup> Ms. Mann transferred to Second Chance “all of her right, title and interest in the improvements, building and fixtures located at 5300 Moorland Lane.”

The IRS selected the Manns' 2011 and 2012 tax returns for audit and disallowed all the donations made to Second Chance. The IRS calculated \$191,638 tax liability in federal income taxes for 2011 and \$2,464 tax liability for 2012, plus statutory interest. The Manns paid the additional tax liabilities and filed a refund claim and an abatement request. They also filed an amended return for 2011 and claimed a deduction of \$313,353 for the house instead of \$675,000. The value of \$313,353 was based on a second appraisal by NoVaStar Appraisals. The value was determined by using the R.S. Means Building Material Cost Estimating Software, wherein the cost of all materials was estimated as new due to nonexistence of well-established second-hand market price for all. The cost of all materials as new accounted for \$377,534 and for depreciation based on an estimated "60 years of economic life with an effective age of 10," bringing the value of the house to \$313,353. The IRS again disallowed the claimed deduction on the amended return. The Manns sought determinations that their original claimed deduction of \$675,000 for the house was valid and sought a refund of \$212,534.22. After learning this, the parties filed cross-motions for summary judgment.<sup>3</sup>

### Court's analysis

#### House donation

With respect to disallowance of the house deduction, the court affirmed the IRS summary judgment request for two reasons. First, the court concluded that the Manns "failed to make a valid transfer of an entire interest in a real property" per Maryland law and per IRC §170(f)(3). Under Maryland law, "real property" includes both land and improvements to land.<sup>4</sup>

Thus, the owner of the land and the owner of the improvements to land is the same in Maryland unless there is a separate recorded deed or other instrument of record showing the transfer of the title to the improvements to another owner.<sup>5</sup> The separation of the land from improvements to the land would be valid only if the transaction was recorded in the land records of Maryland. Thus, record ownership is more important than contractual ownership under Maryland law.<sup>6</sup> The "record landowner" remains liable for paying property taxes on the real property.

The Manns entered a contract with Second Chance for the transfer of improvements at 5300 Moorland Lane but never recorded that transaction in the land records of Maryland. Therefore, Linda Mann was the "record landowner" and retained the ownership of the house. She was liable for property taxes on both the land and improvements even after execution of the contract with Second Chance. Due to this, the Manns "neither transferred their entire interest to Second Chance per 26 U.S.C. §170(f)(3)(A) nor transferred an undivided portion of their entire interest in the

<sup>3</sup> Cross-motions for summary judgment are filed when the dispute is not as to any material fact but it's a matter of law.

<sup>4</sup> Under Maryland law, improvements to land include buildings, any permanent structure or other development.

<sup>5</sup> *GBMC*, 32 A.3d 174 (Md. Ct. Spec. App. 2011).

<sup>6</sup> *Townsend*, 79 A.3d 960, 967 (Md. Ct. Spec. App. 2013).

property per 26 U.S.C. §170(f)(3)(B)(ii).” The court compared the Manns’ donation to granting a license to Second Chance for use of the house for salvage and training purposes.

Also, the appraised value was determined as if the house was moved intact to another lot. However, this claim is incorrect because the Manns donated only a few components; some of the others were destroyed for training purpose and some were demolished. The court determined that the amended deduction value of \$313,353 was also improper as it reflected the value of all the materials in the house being donated for reuse whereas only some materials were donated. The appraisal was overstated by NoVaStar Appraisals, and Second Chance failed to maintain the records of salvaged items. Thus, the Manns “failed to support their donation with a qualified appraisal per IRC § 170(f)(11)(C).”

Second, the court determined that even if the Manns had recorded the transaction in the land records of Maryland, they still would not be entitled to a charitable donation deduction as both the appraisals were not qualified. The appraisals were determined based on the value of all building materials without regard to the few materials that were destroyed, not salvaged and resold. Thus, the appraisals did not value what was actually donated and were overstated. The court provided a correct alternative way to claim the deduction as the resale value of specific building materials actually removed from the house and donated to Second Chance.

### **Personal property donation**

For the personal property deduction of \$24,206, the court ruled that the “appraisal supporting the donation was deficient in several respects.” The appraisal did not provide the specific basis and documentation for the valuation of all 40 items. The valuation was inconsistent as it depreciated the items arbitrarily and failed to include explanation of the basis of the valuation per Reg. § 1.170A-13(c)(3)(ii)(K). The court affirmed the district court ruling and disallowed the deduction for the furniture, home, and components.

### **Cash donation**

The cash donation of \$11,500 was not addressed by the Fourth Circuit Court because it was allowed by the District Court and not challenged on appeal. The lower court allowed this cash donation due to its timing and the view that the Manns did not get a direct benefit from the donation. A donation, to qualify as charitable contribution under §170, must be an unrequired payment without expectation of any specific return. The court held that even though the Manns were required to make cash donations to Second Chance under an arrangement, it was not a *quid pro quo*<sup>7</sup> because the Manns did not receive any specific benefit in return.

The court held that obtaining a tax deduction is not a specific benefit, and if the motivation of tax benefit eliminates the charitable nature of a gift, then no charitable gift would be deductible.<sup>8</sup> Also,

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<sup>7</sup> *Quid pro quo* is a Latin phrase which means “something given or received for something else.”

<sup>8</sup> *Scheidelman*, 682 F.3d 189 (2<sup>nd</sup> Cir. 2012).

the deconstruction services benefitted Second Chance and did not provide any benefits to the Manns, apart from a possible tax deduction. The Manns had no need for the deconstruction services before undertaking the demolition of the house. Also, the deconstruction services did not reduce their cost of demolition.<sup>9</sup> Thus, the Manns were not benefitted from the deconstruction apart from facilitating a charitable donation and its tax deduction. Thus, the Manns were entitled to claim a charitable deduction of \$11,500. When donating cash for removal of house components, it is important to check the details of any similar cash donations as it could be denied based on its nature and collateral benefit.

## Conclusion

A charitable contribution is a donation made to a qualified organization without any expectations of something in return. This case helps us to understand the importance of being proactive and not overlooking the details of the complex charitable contribution rules in the tax law as well as sometimes state property laws that may be relevant. When it comes to charity, substantiation of the items actually donated and proper valuation play a vital role, including proper compliance when a qualified appraisal and/or Form 8283, Noncash Charitable Contributions, are needed.

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<sup>9</sup> *Rolfs*, 668 F.3d 888 (7<sup>th</sup> Cir. 2012).